RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $185 Annually
Registered with the Securities and Exchange Commission

May 6, 1981 — LETTER 808

April 24, DJIA 1020.35; PTI 1467; A-D Ratio –16.12
May 1, DJIA 995.59; PTI 1453; A-D Ratio –17.12

THE PICTURE: Many economists are now forecasting a decline in the inflation rate plus a decline in interest rates over the period ahead. But readers of these Letters know that the Russell opinion is that the debt of this nation can only be handled through the mechanism of rising inflation. Thus, if the inflation rate comes down, the debt will loom *much larger* and servicing the debt will become much more difficult. And I'm only talking about a decline in the RATE of inflation. If we should move to actual deflation, I would predict a collapse, as the task of servicing America's $5 trillion in total debt (under deflationary conditions) would prove utterly impossible.

Let me put it another way. It requires more and more inflation to service a rising debt structure. Thus, if even the *rate* of inflation comes down this is tantamount (in view of the US's towering debt structure) to deflation. The fact is that the monstrous and still growing debt of the US has rendered this economy very brittle, very inelastic – we're walking the razor's edge.

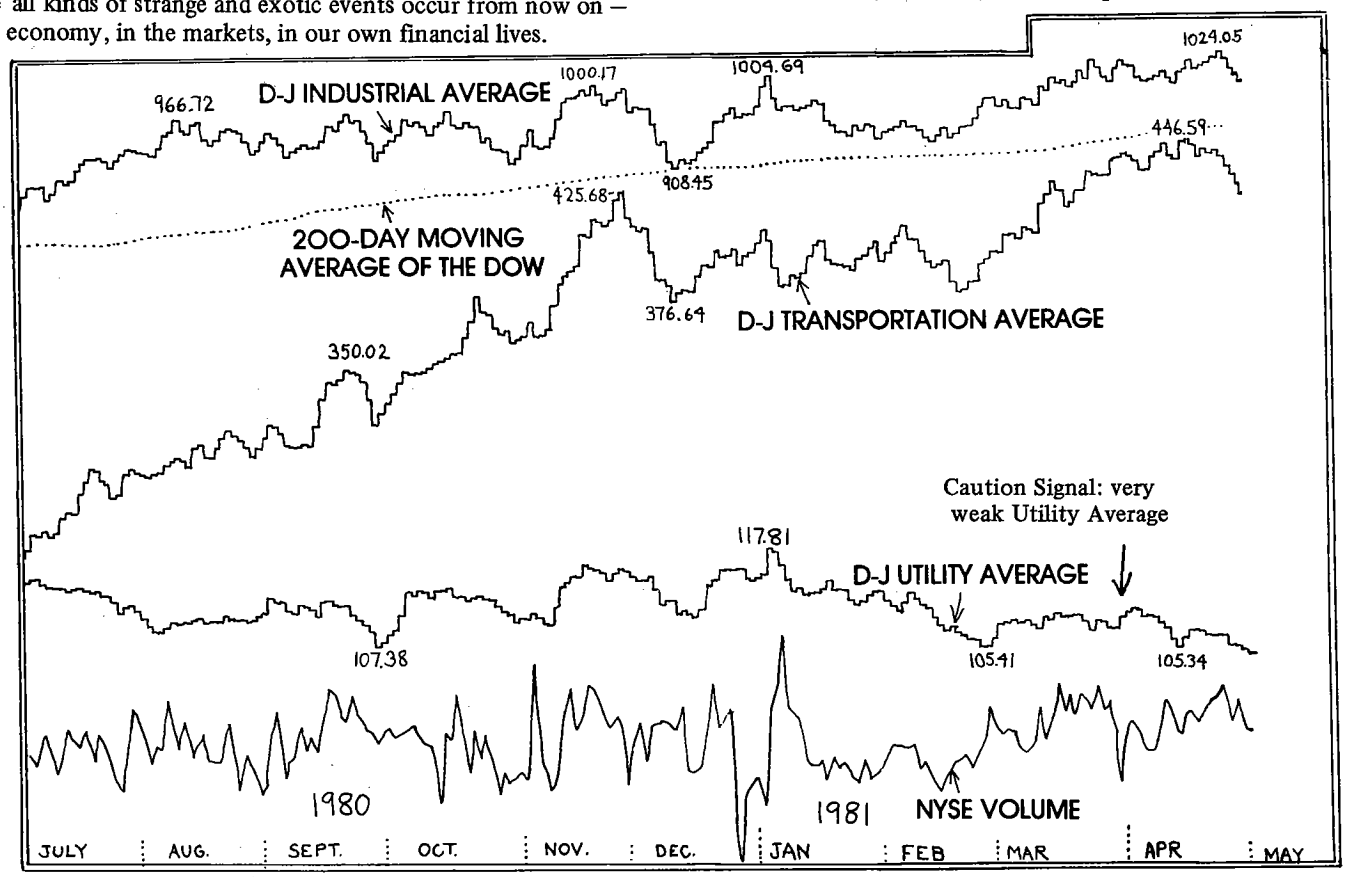
This is also the reason why the next bear market (and ultimately there will be one) could be the most significant one, the most important one, since World War II. The implications of a primary bear market and a contraction in sales and earnings in the face of massive debt-service requirements are, to say the least, frightening. Consequently, I am inclined to play it particularly safe at this time. A nation with a total of $5 trillion in debts of all kinds is a nation that has sailed into unchartered waters. And we can expect to see all kinds of strange and exotic events occur from now on – in the economy, in the markets, in our own financial lives.

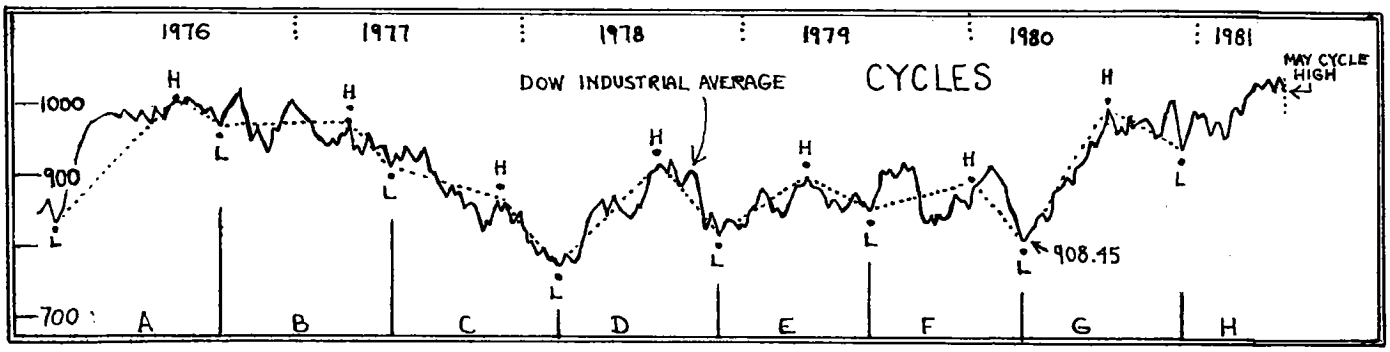
FRONT PAGE COMMENT: If you think the US Government is the only one that is drunk with debts and deficits, forget it. Corporations here now owe $1 trillion. This is up $100 billion from 1979 and triple the amount owed in 1970. In 1975 corporations paid out $57 billion to service their debt but by 1980 the figure had jumped to $115 billion. This $115 billion amounts to 51% of all corporate pre-tax profits, up from 25% in the 1960's! But that's not all – last year 44% of all new corporate debt was short term, compared with only 19% 10 years ago.

Conclusion: corporations, like the Government, are up to their necks in debt and are in poor shape to withstand an economic contraction. The leverage brought on by all this debt is tremendous, and should a severe recession set in corporate profits in the US would all but disappear (as the cost of servicing the debt structure literally wiped out all profits). For this reason, it will be foolhardy to attempt to "ride out" the next bear market with even a minimum stock portfolio.

Meanwhile, the latest US Government figures show a Federal deficit for the first 6 months of the 1981 fiscal year of $65 billion, up 28% from last year's $51 billion. If we don't hit a $100 billion deficit this year, we aren't going to miss it by much.

THE MARKET: On March 25 the D-J Industrial and Transportation Averages bettered preceding secondary highs – and this action reconfirmed the primary bull trend. The action of the market since then, however, has been sporadic, hesitant, skittish.





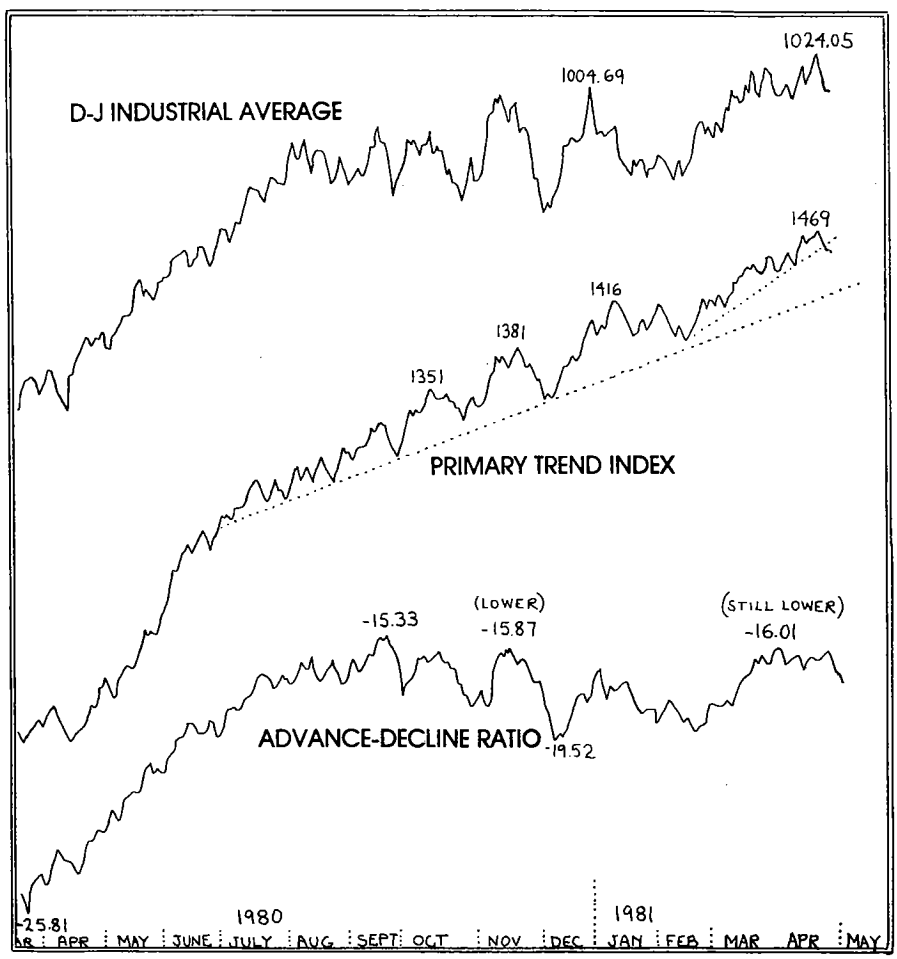
On April 15 the Transports struck an all-time high closing of 446.59 (see chart on page 1). Transports then turned down while the Industrials continued to rally. On April 27 (with a diverging Transportation Average) Industrials recorded a high of 1024.05. Over the next few days the market broke badly with the bond Averages hitting new record lows and the D-J Utility Average flirting with its low of the past year. In all, hardly an impressive performance.

Checkpoints on the downside are the 980-985 "support level" for the Dow and the equally important 940 Dow level (this is the current level of the 50-week moving average of the Dow, as seen on the page 1 chart). Transports and Utilities are now the weaker Averages, and I would expect to see them lead the way on any further general market retreat.

One of the studies that interest me most at this time is my 233–day cycle (see page 2 chart). I discussed this in the last Letter, noting that the bull segment of the cycle (which turned up from the December low of 908.45 on the Dow) is fated to peak around early May. We are now moving into this time frame, and the *cyclical* forces which I study will (from here on) exert a bearish influence on the market. How Wall Street fares during this period will be most important to my general assessment of the market. The Dow gained 114 points during the 144-day bull segment of the 233-day cycle. I want to see what happens during the 89-day bearish segment of the cycle – a segment due to start around now.

Question: Russell, I notice on your page 2 chart that the A-D ratio for the NYSE continues to diverge with the Dow. What does this mean?

Answer: As I've explained in almost every recent Letter, we are witnessing the longest and most flagrant price-breadth divergence in stock market history. The A-D ratio recorded its high in September, 1978, 2½ years ago. That's an unbelievable time lag. The A-D ratio recorded another (lower) peak in September, 1980, and again a still lower peak on April 1 of this year. These descending peaks came in the face of new recovery highs in the Dow. Such action, if past history means anything, is a source of potential danger.

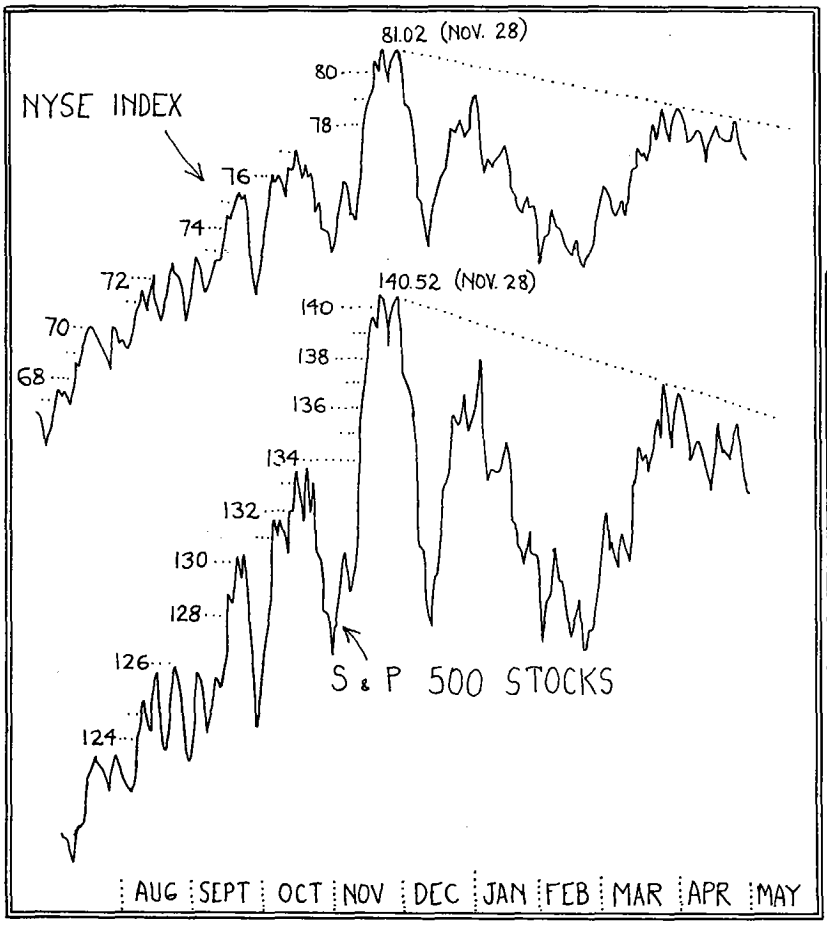


Question: I note that your Primary Trend Index (PTI) made a new high on April 27, and it is still holding above its rising trendline. What do you make of this?

Answer: The PTI is sometimes a lead indicator and sometimes a coincident indicator. The PTI (see chart) has dipped and touched its rising trendline on five successive occasions since mid-1980. But each time the PTI was supported at the trendline–and each time that market rallied to new highs. If the PTI sinks again I will be watching that trendline. If the PTI breaks the trendline, if the PTI begins to trace out a declining trend, we will know that the tide has turned down.

As an aside, noted that the PTI has dipped recently, and on April 30 it fell below a minor trendline as seen on the chart.

Remember, the PTI has had an amazing record of avoiding whipsaws during the rise from February, 1980. When the PTI finally moves into a declining trend, it will be telling us something of vital importance. It will be telling us that this isn't just another market dip, and it isn't just another minor correction. A declining trend in the PTI (when it finally arrives) will be telling us that the technical strength of the market is ebbing and that a bear market has arrived.



COMMENTS: I have mentioned this technical problem repeatedly, but I want to illustrate it now. The daily chart shows that despite the new April highs in the Dow, the broad Averages such as the Standard & Poor's 500 and the NYSE Index have not confirmed. The fact is that the S&P 500 recorded its high of 140.52 on November 28, while the NYSE Index hit its high of 81.02 on the same day. Since then (despite the new Dow highs) the NYSE Index and the S&P 500 have traced out a series of *descending* peaks.

Apologists for these two Averages argue that the energy stocks have been responsible for the weakness. That may well be true, but I never like excusing technical problems on the basis of "this or that." There's always a reason why an important technical divergence occurs. I don't care about the reasons; all I care about is that the divergence exists.

What next? Technically, the figures I am watching are 126 on the S&P 500 and 72 on the NYSE Index. If either of these figures are touched, I will consider the trend of the broad market (as measured by these Averages) to be bearish. Mark those figures down, and during any sustained decline watch those points. The two points are of major importance, and will be crucial in any test of market weakness during the period ahead.

Here's another comment I want to make. In past Letters I've written, "Watch the intelligent Wall Street analyst who has been right for a long time. He's moving closer and closer to the point where he is going to be wrong. Conversely, watch the talented Wall Streeter who has been wrong for a long time: he's moving towards a dramatic "correct call."

Joe Granville has a large following, and his January 6 "sell" signal was subsequently derided, laughed at, scorned. By April everybody hated or made fun of Joe. I've felt that Joe would be proven correct at just about the period of peak disbelief in his now famous January 6 bear market forecast. We may be near there now. In his latest report, Joe is more adamant than ever. He says that "This is NOT the 1978–81 bull market when my sell signals averaged drops in the Dow of 100 points. This is a BEAR market, something we haven't seen in four years." Well, I'm not laughing at Granville, he could just be right – but just a bit too soon for Wall Street's "perfect-timers."

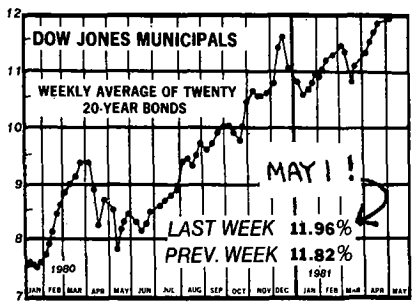
INVESTMENT POSITION: No change from the last mailing. With 91-day Treasury bills yielding well over 14%, and with the trend of the bond market down, there is little risk/reward in holding anything but T-bills. My bet is that the wisdom of holding "mostly T-bills" will be made dramatically apparent before this year is out.

May I suggest that all subscribers buy and study the soft–cover book entitled "Compound Interest and Annuity Tables " (McGraw Hill, $4.95). Item from the book – at 14.5% compounded quarterly, $1,000 becomes $4,114 in 40 quarters or 10 years. Pension fund managers might make a note of that!

INTEREST RATES: As if hypnotized, the nation's economists have been blabbing about "lower interest rates" all through 1981. I've disagreed in Letter after Letter. Now the full extent of their miscalculations are beginning to hit Wall Street – in their pocket where it hurts!

The bellwether of the short-term market, the 91-day Treasury bill, moved over the 14% yield level last week, thus reversing the declining trend of the past few months (i.e., reversing the trend of yields to the upside). At the same time, the bellwether of the long-term market, the 12¾ of 2005-10 Treasury bonds, broke to record lows under 96 to yield 13.30%.

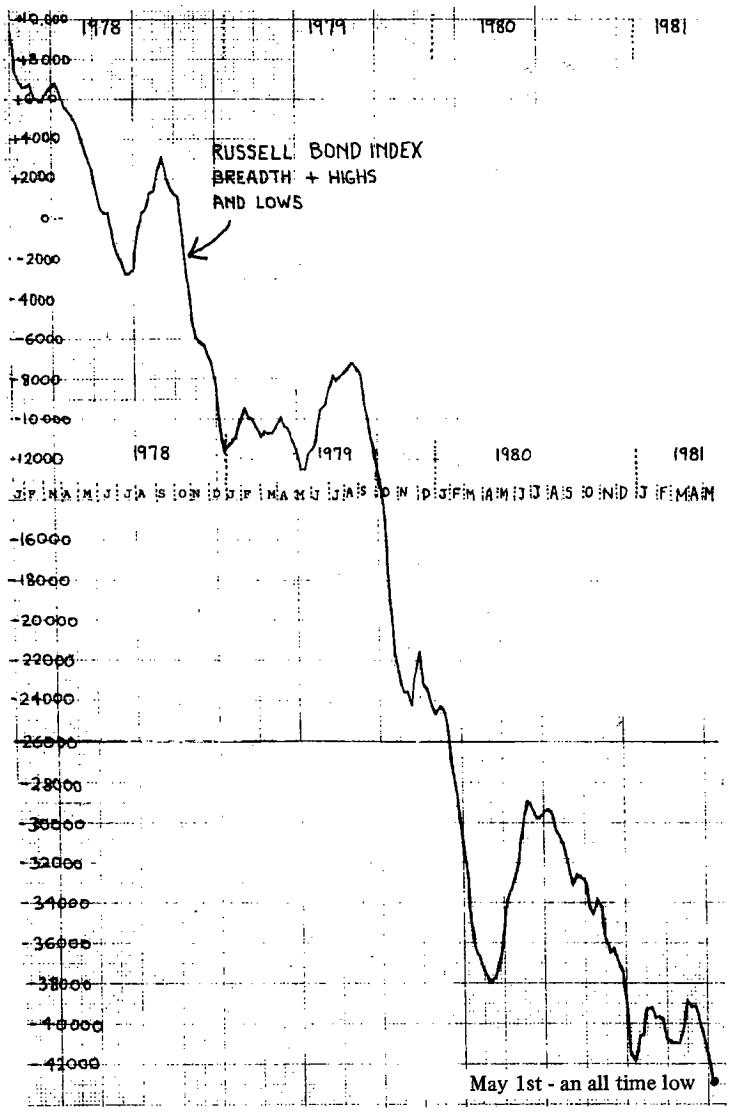
At the same time the D-J Municipal Bond Average fell to an all-time low, and this tax-exempt Average now yields a record 11.82%. Long-term holders of Muni bonds now show losses of anywhere from 25% to 40%. This chart shows what has happened to Muni yields since early 1980.



On April 27 an AAA (top) rated bond set a yield record when Michigan Bell Telephone brought out a 40-year debenture priced to yield 15.93%. At 15.93%, money doubles in less than five years!

Despite what you have probably read in other services ("Buy the bonds, they're bargains") I have steadfastly warned against holding anything over two-years in the way of maturities. But in case you don't understand I'll repeat it – avoid, stay out of, eschew bonds. Their time has not yet arrived!

On page 4 is the very helpful Russell Bond Index, a broad measure of bond action. This index is made up of the daily declines and new lows (on the NYSE bond list) subtracted from the daily new advances and new highs. Here we see what can be considered



the bond counter-part of 1929-32 in the stock market. This collapse affects every bond fund, bank, insurance company, S&L, and pension plan in the country. What you see on this chart represents losses in the hundreds of billions of dollars!

For our purposes, it tells us that there is yet no major turn in the bond market. It also tells us that when the turn finally does come, there will be A LOT OF ROOM AND TIME on the upside – so don't get impatient. Thank you.

THINGS I THINK ABOUT: (1) If oil prices buckle (and they could), would that hit gold too? Recent history indicates that oil and gold tend to move together – at least in direction.

(2) Something happens to politicians when they get to Washington, but I'm not sure just what it is. Most of them go through some kind of "compromise syndrome," and what ever they stood for before becomes fuzzy in Washington-land.

(3) Speaking of compromise, whatever happened to President Reagan's promise to eliminate the Departments of Energy and Education? And why is he kidding himself about balancing the budget (with huge new budget deficits coming down the road)?

(4) Ernst & Whitney, one of the "Big 8" accounting firms, reported that on an inflation adjusted basis, US corporate profits were actually 41% lower than announced. In a study of 50 major companies, the companies reported that they paid out 33% of their profits in dividends. Realistically, they paid out 70%. In due time, companies will have to replace old plant and equipment at the current inflated prices, and when this happens the squeeze will be on profits. The fact is that companies have been paying out a large percentage of their assets in the form of dividends (while many borrowed at the same time). This form of stupidity cannot last. Example: Ford Motors, which lost a fortune over the last year is still paying out scarce cash in the form of dividends. Why? To bolster the stock and retain its dividend record. Dream on.

(5) What happened to Jimmy Carter? Have you ever seen an ex-President disappear so TOTALLY from public view. Well, if ever a man had a reason to hide .....

(6) The tax take from gambling in Nevada is so great that there is no state tax and no inheritance tax in that desert state. Yet in spite of the evidence, hundreds of thousands of people go to Reno and Vegas every year to lose their money. What are they thinking about? How can they justify it? I can never really understand the mentality of a gambling-loser. Is it "Hope springs eternal"? Or is it that they just don't care about the odds? Or is it just masochism?

(7) Most of the commodities look as though they are basing. But the commodities usually *don't* form such long, "obvious" bases prior to a rise, and I wonder if we aren't seeing "fake-out" bases that will just prove to be traps. From all quarters, the "expectation" is that food prices will be vastly higher in 1982.

(8) Suddenly, everybody wants to own a brokerage house, and its "merge-city" for the brokers. It's easy to see why they want to own a brokerage firm. Look at the money pouring into the brokers via the money market funds. Note that many leading brokers are now literally financial department stores, and they are selling stocks, bonds, insurance, tax shelters, money market funds, oil and cattle programs, you name it.

(9) The survivalist trend (rage) has been going on for almost a decade. I sense that the movement is tired, almost spent. My own theory is that the trouble isn't going to come with one fell swoop in which we're all going to have to grab for guns and dried food. It's going to be a long series of frustrations and bureaucratic stupidities. My guess is that there will be martial law in the US before there will be "blood in the streets."

(10) Throughout most of American history, the Presidents led the people – they were literally ahead of the people. Not so since Vietnam. The people ended the Vietnam war, despite Kennedy and Johnson (and, if you remember, the first Vietnam protesters were the "Hippies"). Now the people want a balanced budget and and end to inflation. And although the Reagan Administration floated in on that desire, the Reagan boys haven't quite got the guts to even try to deliver the goods.

Recently, seven Congressmen reported that in talking to their constituents, there was very little desire for tax cuts in 1981 and beyond. What the people DO want is a balanced budget. Their objection to a tax cut was that it would aid inflation, it would

INTERVIEW: "W" magazine last week presented what I thought was a very important interview with Lester C. Thurow, economics professor at MIT (Thurow is author of the book, "The Zero-Sum Society"). I felt that many of Thurow's points were so incisive that they were worth repeating in this Letter, and here are some excerpts:

Applied to our slow-growth or no-growth economy, he says if one group's income goes up, another group's must go down. To beat problems such as inflation, somebody will have to get hurt. Since in a democratic society we all push to see that the hurt falls on the other guy, solutions, says Thurow, are tough to find.

Also, he thinks this country is losing the competitive war with countries such as Japan and West Germany.

Whatever the solutions may be, he says the administration's economic program does not have them. A "liberal Democrat" who once worked on the staff of President Johnson's Council of Economic Advisers (before the Vietnam war), the 42-year-old Thurow thinks the Reagan strategies are "dead wrong."

"They'll work in the beginning because of the defense-spending buildup," he predicts, "but they'll start to come apart some time in late 1982 or early 1983.

"Productivity has been falling since the third quarter of 1977 and is now falling at the rate of 1 percent a year," he points out. "Everybody's standard of living has to go down. We invest about 11 percent of our Gross National Product, while Japanese investment is running at about 20 percent of GNP. How can we keep up? We're not that much smarter than they are.

"Our savings rate is 5 percent of income. The West Germans save 14 percent and the Japanese, 20 percent. We've made it too easy to consume without saving. In Japan, you have to pay cash for a car and you can't buy a house with just a 10 or 20 percent down payment. Credit is too easy here. We have to restrict credit."

"Consumption has to go down, and you can't do it without hurting somebody," he says. "You have to take something from somebody."

From 1941 to 1965, Thurow claims, the United States was "technologically superior to everyone else, and foreign trade didn't make much difference to us — but in the past 20 years, foreign trade has gone from 5 percent of GNP to 15 percent."

"Now," he adds, "like Germany and Japan we have to export to survive. We're in a competitive world, something we didn't have before. If we are to compete with efficient countries and we're inefficient, they'll just drive us out of business."

As for Reagan's plans to increase defense spending, Thurow points out that the buildup for the Vietnam war between 1965 and 1969 was $26,700,000,000, which, adjusted for inflation, comes to about $60 billion. Between 1980 and 1984, Reagan plans to boost military spending by $150 billion, or 2½ times what Vietnam cost.

"If Johnson was to blame for inflation because he didn't raise taxes to pay for the Vietnam war, we should be raising taxes now," says Thurow.

Reagan's planned attack on government regulations also is doomed, he says.

"I think Reagan is being naive in expecting that he can speed up the regulatory process by directing the regulators not to enforce the law. He thinks he can put someone in the Environmental Protection Agency who would overlook the law. If the law isn't enforced, everything will go to court. The judges will be running the country.

Thurow expects the administration to get most of what it wants — just about all the tax cuts and defense-spending increases and about 75 percent of the spending cuts.

"The most likely scenario is a repeat of Vietnam. The first year or two will look good. Unemployment will fall and inflation won't get worse until we run into capacity restraints. Then inflation will worsen. When Vietnam started we had productivity growth. Now we don't have it. Productivity will improve at the beginning as the economy expands, but unless Reagan balances defense spending with cuts in consumption, the policy will fail.

"They say we won't have to ask for any sacrifice. They'll try it and then run into more inflation. What their answer will be then, I don't know."

There will have to be some sacrifice by Americans if we are to avoid the same fate as the British, he says. We're competing with the Germans and the Japanese and if they don't take vacations, we won't be able to either. If they work and save a lot, we'll have to do the same thing.

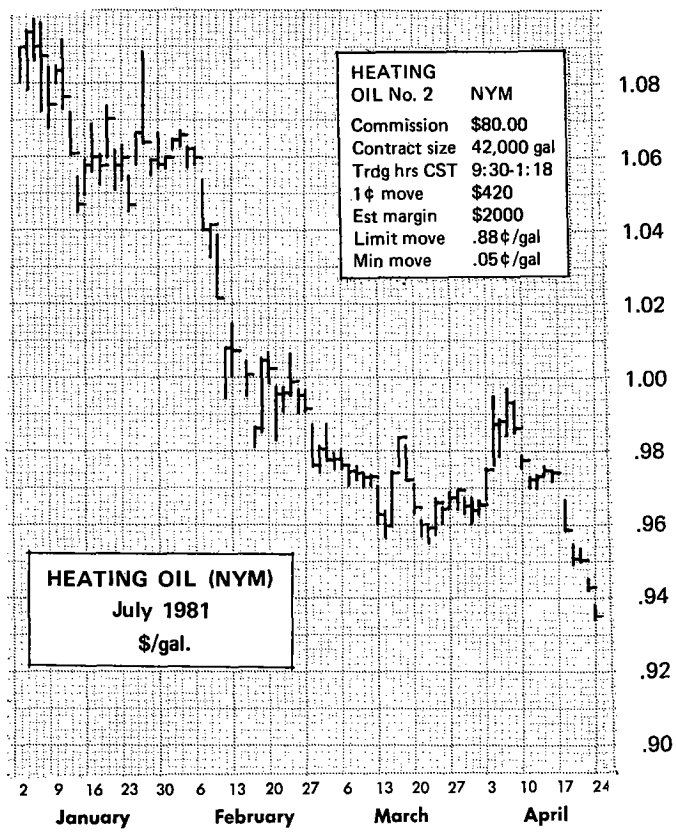
"We have no choice but to cut private consumption. If not, we'll be like Britain whose per-capita income is now below East Germany's. In 100 years, Britain has gone from being the richest country in the world to being the poorest country in the industrial world. The North Sea oil didn't really help Britain. It merely made it possible to postpone action to solve their problems.

"If we don't do something, the same thing will happen to us and it won't take us a century. We now rank tenth among the industrialized nations in per-capita GNP. Just one year ago, we were fifth."

unbalance the budget and it "wouldn't do me any good anyway, it wouldn't make that much difference to me." Congress senses this, and for that reason I would not be surprised to see the Reagan program rearranged by Congress with cuts in the budget increases and very little in the way of tax cuts. The people want A BALANCED BUDGET AND AN END TO INFLATION, and somehow Reagan seems to be losing sight of his original goals.

Dr. Murray Rothbard (a great Libertarian) put it this way in an open letter to the President: *"There are no budget cuts, there are no tax cuts in your program. There is no Reagan Revolution. Despite the fuss and fury, sir, nothing is happening."*

I include this chart because it is one that few readers see, yet it is a most vital chart for the market and the economy. Here you see the trend of heating oil (July futures) as it breaks from last year's $1.10 to the recent price below 94 cents. I guess this comes under the category of "They said it couldn't be done, " but as all market people know, the price of EVERYTHING is subject to supply and demand, even oil, even gold. (Chart Courtesy of Dunn and Hargitt, 22 North Second, Lafayette, IN 47902).



GOLD: Most people fail to reap big profits in the markets because they don't see or comprehend the major, long-term moves. And one reason for that failure is that it's very hard to detect the very long-term trend of any item.

On page 6 is a 14 year chart of gold (monthly), and this chart provides some clue as to the major trend of the yellow metal. From 1967 to 1979 (13 years) gold held within the confines of the rising channel labeled A-B on the chart. In late 1979 and during much of 1980 gold pushed above the upper con-

fines of the channel. This move was a result of speculative excess (I labeled it such at the time), and the result was a vicious correction.

During late 1980 and all through this year gold has held within the A-B channel again, and it appears to me that this is a corrective move – not a primary bear market for gold. I base this on two considerations. First, gold has held within the top portion of the A-B channel – rather impressive when you realize that the decline is now over a year old. Note also that gold has held above the secondary trendline marked C on the chart.

Second: the gold shares, although hit hard, have not collapsed as they did during the 1974-76 smash. The fact is that the gold shares (at least so far) act as if they are in a correction rather than a bear market.

I have said all along that I believe gold has completed its first and second bull market phase with a third phase still to come. The third phase could be based on a vicious contraction in the economy – followed by a Federal Reserve attempt at monetizing the staggering accumulation of new debt brought on by that economic contraction.

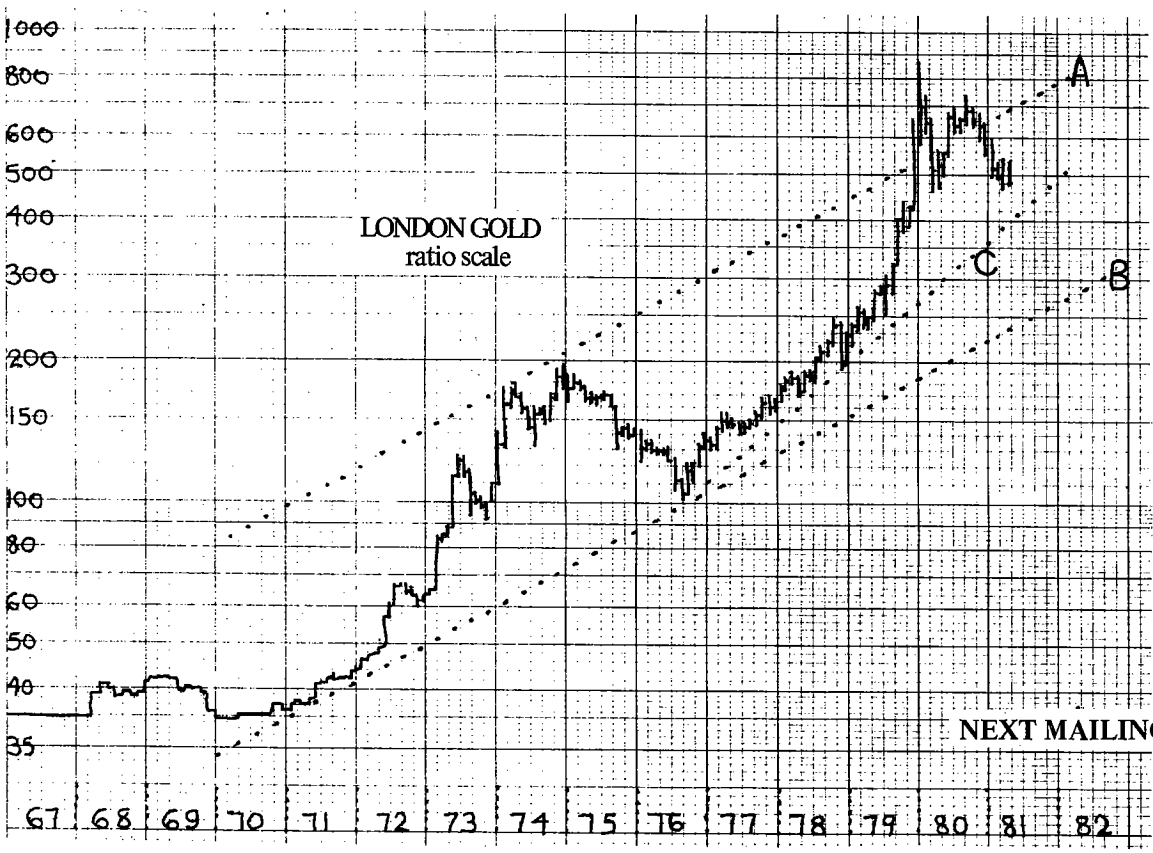
I think it will be impressive if gold can hold above trendline C during the period ahead. And if gold during any forthcoming rise succeeds in bursting above trendline A, I would say that the third phase of the gold bull market was in full swing.

How about the timing of a possible third phase in gold? It is always easier to IDENTIFY than predict, but I would say that (1) the longer gold holds above trendline C, the better the chance for a forthcoming third phase, and (2) my guess is that the base for a third phase rise in gold should be completed during 1981 or early 1982.

From the near-term, a rally above 505 (spot) would be bullish for the gold pattern and would imply that gold was forming a large base. Conversely, a drop by gold below 472 would be bearish, implying a test of the 457 low.

LATE NOTES: With the decisive breaking of the minor rising trendline on the PTI, it would seem that another testing of the main rising trendline is in order. How this test fares will give us a major clue as to the state of the market. Remember, the long rising trendline on the PTI has been tested and re-tested ever since June, 1980. What happens next is going to be most interesting – and crucial for the major trend of the market.

QUESTION: What's happened to America's great middle class? Answer: only the New Yorker Magazine knows, and I had to dig the answer out from one of their recent cartoons. Here it is. . . . .



NEXT MAILING: May 20